DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 98-0716
INDIANA CORPORATE INCOME TAX
For the Tax Years 1995, 1996, and 1997

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of the document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUE

I. Applicability of Gross Income Tax to Commissions Attributable to the Sale of Mutual Funds by Out-of-State Independent Agents.

Authority. IC 6-2.1-1-2; IC 6-2.1-2-2; IC 6-2.1-3 et seq.; IC 6-2.1-4 et seq.; IC 6-8.1-5-1; Indiana Dept. of Revenue, Gross Income Tax Division v. Beemer Enterprises, Inc., 386 N.E.2d 187 (Ind. App. 1979); 45 IAC 1-1-96.

Taxpayer protests the assessment of Gross Income Tax against commissions attributable to the sale of mutual funds in various foreign states.

II. Apportionment of Taxpayer's Commission Income for Purposes of Calculating Adjusted Gross Income and Supplemental Net Income Tax.

Authority. IC 6-3-2-2; 45 IAC 3.1-1-38.

Taxpayer protests the audit's determination that it was unnecessary to apportion taxpayer's income based on audit's decision that taxpayer was not "doing business" in any foreign state.

III. Request for Abatement of the Ten-Percent Negligence Penalty.

Authority. IC 6-8.1-10-2.1; 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

Taxpayer requests that the Department of Revenue (Department) exercise its discretion to abate the ten-percent negligence penalty made against taxpayer's additional corporate income tax assessment. Taxpayer argues that because the additional assessments are entirely erroneous and violative of the Department's regulations, state statutes, and the United States Constitution, the ten-percent negligence penalty is patently without merit.

STATEMENT OF FACTS

Taxpayer is an in-state "broker/dealer" – registered and designated as such for securities law purposes – and receives commissions attributable to the sale of mutual funds in various foreign states. During the years at issue, taxpayer was registered and qualified to do business in Indiana and in 24 additional states in which it paid income and/or franchise taxes. Taxpayer is a wholly owned subsidiary of in-state insurance company (hereinafter "parent insurance company"). For purposes of Indiana's gross income tax, taxpayer reported only those commissions attributable to sales to Indiana customers.

The audit determined that the commissions received as a result of out-of-state transactions were subject to gross income tax and, as a consequence, assessed additional tax liability. In arriving at that conclusion, the audit determined the commissions were paid by parent insurance company, all applications for the sale of equity products were reviewed and accepted by taxpayer's in-state office, taxpayer had no employees or physical presence outside Indiana, and that taxpayer did not establish a business situs outside Indiana. Accordingly, under the provisions of IC 6-2.1-2-2 and 45 IAC 1-1-51, all of the commissions – received from both in-state and out-of-state transactions – were subject to the state's gross income tax.

In addition, because the audit determined that taxpayer had no business situs outside of Indiana – for purposes of determining taxpayer's adjusted gross and supplemental net income tax liabilities – it was not necessary to apportion the taxpayer's income between Indiana and the foreign states.

Although registered as a "broker/dealer," the taxpayer maintains that it acted neither as a "broker" or a "dealer" within the meaning which the Department has attributed to those terms for gross income tax purposes. Taxpayer predicates this assertion on the fact that it did not itself purchase any of the mutual funds, did not sell any of the mutual funds, and did not "arrange" to sell any of the mutual funds.

Taxpayer argues that the audit's factual and legal conclusions are both erroneous. To that end, taxpayer describes its business arrangements as follows:

1. Independent out-of-state agents sold mutual funds to out-of-state customers.

2. The independent out-of-state agents did not sell parent insurance company's mutual funds.

3. The mutual funds sold by out-of-state agents were those of third-party mutual fund vendors.

4. The independent out-of-state agents used application forms in their marketing activities which were supplied by the third-party mutual fund vendors.

5. The independent out-of-state agents filled out, or assisted the out-of-state customer to fill out, the application forms.

6. The independent out-of-state agent forwarded the completed application form, along with a check made out directly to the third-party mutual fund vendor, to the taxpayer for the taxpayer's review and processing "as required by securities laws."

7. The application was then forwarded to the third-party mutual fund vendor, which accepted or rejected the application, cashed the check, established the mutual fund account on behalf of the out-of-state customer, and confirmed the transaction and account with the out-of-state customer.

8. The commissions which taxpayer received did not derive from the sale of parent insurance company's mutual funds.

9. The commissions derived from the sale of mutual funds were not paid to parent insurance company by the third-party mutual fund vendors.

10. The commissions derived from the sale of equity products were paid directly to taxpayer pursuant to various "agreements" with the third-party mutual fund vendors.

11. The taxpayer received commissions, attributable indirectly to the sale of the mutual funds, both at the time the out-of-state customer made the initial investment in the fund and after each time the out-of-state customer made a subsequent addition to the fund.

In summary, independent out-of-state agents sold mutual funds to out-of-state customers. The mutual funds were those of third-party mutual fund vendors entirely unrelated to the equity products sold by parent insurance company. Third-party mutual fund vendors paid taxpayer commissions attributable to the sale of these particular equity products. The commissions did not flow through and were not attributable to parent insurance company. According to taxpayer, "all sales generating commissions were consummated at out-of-state offices of the third parties." While conceding that the commissions were "attributable to the sale of [the] mutual funds," the taxpayer maintains that it did not engage in purchasing the mutual funds, selling them to others, or in negotiating for the sale of the funds on behalf of the third-party mutual fund vendors to the out-of-state purchasers.

Taxpayer sets forth various legal arguments challenging the validity of the gross income tax assessments. According to taxpayer, the additional assessment conflicts with both Departmental regulations and the relevant state statutes. However, taxpayer's protest centers on the argument that the assessment is invalid because it violates the Interstate Commerce Clause of the United States Constitution.

Similarly, taxpayer challenges the audit's determination that it was unnecessary to apportion taxpayer's income for purpose of calculating Adjusted Gross and Supplemental Net Income tax assessments. The audit concluded that taxpayer was not "doing business" in any other state because it had no business situs outside of Indiana and that apportionment of the taxpayer's income was not warranted.

I. Applicability of Gross Income Tax to Commissions Attributable to the Sale of Mutual Funds by Out-of-State Independent Agents.

Gross income tax is imposed upon the receipt of the entire taxable gross income of a resident or domiciliary of Indiana. IC 6-2.1-2-2. The term "taxable gross income" means all gross income which is not exempt from tax under IC 6-2.1-3 et seq. less all deductions which are permitted under IC 6-2.1-4 et seq. In particular, IC 6-2.1-1-2 provides that "'gross income' mean all the gross receipts a taxpayer receives (1) from trades, business, or commerce . . . ." In regards to the taxpayer's own commission income, 45 IAC 1-1-96 provides that "[g]ross receipts from services means receipts derived from activities performed in the process of completing a service agreement or contract . . . Such income includes, but is not limited to commissions, fees, receipts from service contracts, or income from similar sources." Accordingly, taxpayer's commission income would appear to fall within the state's authority to impose the gross income tax.

However, that authority is not entirely unfettered. In Indiana Dept. of Revenue, Gross Income Tax Division v. Beemer Enterprises, Inc., 386 N.E.2d 187 (Ind. App. 1979), the court held that the taxpayer's commissions were not subject to the gross income tax. In that case, Beemer was an Indiana corporation retaining the services of commissioned salespersons outside of the state. Beemer had an agreement with a Pennsylvania corporation allowing it to act as the Pennsylvania corporation's sales representative. The Pennsylvania corporation supplied order forms to Beemer's out-of-state salespersons. The out-of-state salespersons forwarded orders directly to the Pennsylvania corporation. The Pennsylvania corporation manufactured its merchandise outside of Indiana and shipped its orders directly to the out-of-state customers. In consideration for the activities of Beemer's out-of-state salespersons, the Pennsylvania corporation paid Beemer a sales commission. The court held that the commissions derived from the out-of-state salespersons' activities in selling products that were produced, ordered, and delivered entirely outside of Indiana were not subject to the gross income tax. The court stated that "it was led to the inescapable conclusion that the State of Indiana may not tax commissions which are generated from the interstate sales of products." Beemer at 190.

As described by the taxpayer, its activities would seem to fall within the exemption defined by the court in Beemer. The taxpayer asserts that its salespersons generated sales on behalf of out-of-state third-party mutual fund vendors. The third-party mutual fund vendors supplied the salespersons with the necessary order forms. The salespersons were engaged in selling "products" which were supplied by the third-party mutual vendors. The out-of-state customers made payments to the third-party mutual fund vendors.

However, the Department's audit of taxpayer made a determination which differed from taxpayer's own description of the manner in which the taxpayer received the commissions. The audit found that the commissions were paid to the taxpayer not by the third-party mutual fund vendors, but were paid to the taxpayer by the taxpayer's own parent insurance company. That determination echoed an identical finding within an audit conducted in 1995. If, as the audit determined, the commission was derived as the result of a business arrangement between itself and the parent insurance company, the income was derived from a transaction conducted and completed entirely within the state and falls outside the interstate commerce exemption as set out in Beemer.

Under 6-8.1-5-1(b), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." The taxpayer was fully aware that the audit determined, on two separate occasions, that the commission payments were made by the parent insurance company to the taxpayer. That determination could have been refuted by specific evidence concerning the relationship between the parent insurance company and the taxpayer. That determination could have been refuted by specific evidence of the contractual relationship between the third-party mutual fund vendors and either the taxpayer or the parent insurance company. Taxpayer's bare averments are decidedly insufficient to overcome the presumption afforded under IC 6-8.1-5-1.

FINDING

Taxpayer's protest is respectfully denied.

II. Apportionment of Taxpayer's Commission Income for Purposes of Calculating Adjusted Gross Income and Supplemental Net Income Tax.

The audit determined that, for apportionment purposes, the taxpayer was not "doing business" in any other state and that no apportionment of the commission income was required. The taxpayer disagrees stating that, based upon the activities of independent out-of-state agents, the income attributable to the activities of those independent out-of-state agents must be apportioned.

Under Indiana law, the taxpayer's business income is subject to the apportionment formula set out in IC 6-3-2-2. Central to that formula is the determination of whether or not the taxpayer is "doing business" within the state. 45 IAC 3.1-1-38 sets out the rule:

> For apportionment purposes, a taxpayer is "doing business" in a state if it operates a business enterprise or activity in such state including, but not limited to:
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> (1) Maintenance of an office or other place of business in the state
> (2) Maintenance of an inventory or merchandise or material for sale distribution, or manufacture, or consigned goods.
> (3) Sale or distribution of merchandise to customers in the state directly from company-owned or operated vehicles where title to the goods passes at the time of sale or distribution
> (4) Rendering services to customers in the state
> (5) Ownership, rental or operation of a business or of property (real or personal) in the state
> (6) Acceptance of orders in the state
> (7) Any other act in such state which exceeds the mere solicitation of orders so as to give the state nexus under P.L. 86-272 to tax its net income.

The audit determined that none of the taxpayer's out-of state activities brought it within the purview of the regulation. Taxpayer argues that, based upon 45 IAC 3.1-1-38(7), the audit erred and that the commission income should be apportioned. As taxpayer states, "the commission income received by the Taxpayer was attributable to marketing services provided by independent agents on behalf of the Taxpayer in the states in which the Taxpayer was subjected to income and/or franchise tax during the Period in Issue."

However, the taxpayer also states that it "never purchased any of the securities (mutual funds), nor did it sell any of the mutual funds or 'arrange the purchase and sale' of mutual funds on behalf of others." Taxpayer further states that the income was "received for out-of-state marketing services in marketing mutual funds sold by unrelated, out-of-state third-party mutual fund families. The Taxpayer did not establish or carry accounts for the purchasers of mutual funds, and the Taxpayer did not determine or 'negotiate' terms for the purchase and sale of mutual funds." Taxpayer summarizes its activities stating that it "engaged in marketing – it did not engage in purchasing funds and selling them to others or in negotiating terms for the sale of funds from fund families to purchasers."

The taxpayer argues that the income at issue should be apportioned because the activities of the out-of-state agents "exceed[ed] the mere solicitation of orders so as to give the [foreign] state nexus under P.L. 86-272 to tax its net income." 45 IAC 3.1-1-38(7). Taxpayer's argument would have a certain cogency except for the fact that the out-of-state agents are not the taxpayer's, the products being sold by the agents are not the taxpayer's products, and the taxpayer admittedly played whatsoever no role in the "purchase and sale" of the products.

Any causal relationship between the out-of-state sale of the mutual funds and the receipt of the commission income is simply too amorphous to justify a finding that the taxpayer was "doing business" within the foreign state and that, as a result, the commission income should be apportioned.

FINDING

Taxpayer's protest is respectfully denied.

III. Request for Abatement of the Ten-Percent Negligence Penalty.

Taxpayer has requested that the ten-percent negligence penalty, imposed under authority of IC 6-8.1-10-2.1(a), be abated. The taxpayer argues that the penalty is "patently without merit." The penalty was assessed against taxpayer's corporate income tax liabilities determined for the tax years 1995, 1996, and 1997.

IC 6-8.1-10-2.1(d) states that if a person, subject to the negligence penalty, imposed under IC 6-8.1-10-2.1(a), can show that the failure to file a return, pay the full amount of tax shown on the person's return, timely remit tax held in trust, or pay the deficiency determined by the Department, was due to reasonable cause and not due to willful neglect, the Department shall

waive the penalty. 45 IAC 15-11-2(b) defines "negligence" as the failure to use the "reasonable care, caution, or diligence, as would be expected of an ordinary reasonable taxpayer." Negligence results from a "taxpayer's carelessness, thoughtlessness, disregard, or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations." Id.

In order to waive the negligence penalty, the taxpayer must demonstrate that its failure to pay the full amount of tax due was due to "reasonable cause." 45 IAC 15-11-2(c). Taxpayer may establish reasonable cause by "demonstrat[ing] that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . . ." Id. In determining whether reasonable cause exists, the Department may consider the nature of the tax involved, previous judicial precedents, previous Department instructions, and previous audits. Id.

Taxpayer prepared and submitted 1995, 1996, and 1997 tax returns based upon an interpretation of the law which was found to be erroneous during the 1995 audit. Taxpayer chose to discount the 1995 determination and, for three consecutive years, continued to file tax returns in adherence with its previous interpretation of the tax laws and regulations. Although the taxpayer chose not to protest the 1995 audit, it undoubtedly realized that something was amiss. However deeply felt its position may have been, taxpayer's decision to ignore the results of the 1995 audit takes that decision out of the "ordinary business care" standard necessary for the Department to grant the taxpayer's request.

FINDING

Taxpayer's protest is respectfully denied.

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